AN INVESTIGATION INTO THE DOCTRINE OF PROPER PURPOSE

by

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Only my parents, Judy and Ann really believed that the start would culminate in the finish. To them this modest work is dedicated.

C O N T E N T S

CHAPTER ONE

INTRODUCTION

The doctrine of proper purpose relates to the manner in which directors exercise their powers. Its origins are to be found in the fiduciary relationship in which a director stands towards his company and the concomitant duty that this relationship imports, namely, to use his office and to exercise his powers bona fide in the interests of the company. The significance of the doctrine lies in the separation of the duty to act bona fide in the interests of the company, from the duty to exercise a fiduciary power for the purpose for which it was intended and not for some improper motive. According to the doctrine, the acts of directors may be invalid if they exercise a fiduciary power for an improper motive, despite the fact that they acted on what they bona fide believed to be in the interests of the company. Inherent in the doctrine is the conflict between the exercise by directors of their managerial powers in terms of the memorandum and articles of association of the company, and the right of the majority of the shareholders to pursue whatever policy they choose within the company's power, together with the prohibition which rests on either party to usurp the rights of the other.

'Issue of Shares'

This thesis will address the circumstances leading up to the establishment of the doctrine, and the attitude of the Courts to the doctrine. In this regard there will be an examination of the nature of the office of the director and the obligation which rests upon the directors in the discharge of their fiduciary duties; the nature and development of the doctrine of proper purpose; and finally, the conclusions reached.

N.B. While there may be considerable doubt as to what the precise nature of the office of a director is or what the exact position is that he occupies in law, and while the term director may not admit of comprehensive definition, there is no doubt that a director stands in a fiduciary relationship to his company. Robinson As a result he has the duty to act in good faith towards his company, to exercise his powers as a director for the benefit of the company and to avoid a conflict between his own interests and those of the company. (1)

The basic fiduciary duties which flow from this relationship between a director and his company are that he must use his office and exercise his powers bona fide in the interests of the company and that he must not place himself in a position in which his personal interests conflict, or may possibly conflict with his duties to the company. (2) Alexander; Robinson

The above is clear, but what is the position where a director fails to exercise the power delegated to him for the purposes for which they were conferred? Traditionally, proper purpose has never been a head of directors' duties, and the investigation is directed at whether the formulation of a director's duty to exercise his powers for their true purpose has acquired a specialised meaning. This obligation upon directors to exercise their powers for proper purposes is an obligation which is viewed sometimes as a variant of the duty to act bona fide and at other times something distinct therefrom. (3).

Rebuy'slate v Melvyn

This gives rise to a question which is cardinal to the subject under discussion. Accepting that it is a basic duty of a director to act bona fide in the interests of the company, is it open to directors to say (on an objectively sound basis) that they genuinely believe that what they are seeking to prevent the majority of shareholders from doing will harm the company and that, in taking action whereby the majority can be outvoted, they properly exercise their fiduciary duties and there should be no interference with such action? In other words, is it sufficient for the Court to establish that subjectively the directors acted bona fide in the interests of the company or must the Court go further and determine objectively whether the power was exercised for an improper motive?

The answer to this question gave rise to the doctrine known as the proper purpose doctrine, when in Hogg v. Cramphorn (4) it was decided that a genuine belief that the directors were acting bona fide in the interests of the company, even if well founded, is irrelevant, if the power to issue shares, which is a fiduciary power, was exercised for an improper motive. Such an issue was liable to be set aside. This marked a new approach, that is, where bona fides on the part of the directors was expressly found, but their purpose was nevertheless declared improper and their decision struck down (or at least, referred to the general meeting for consideration). It would seem that, in the light of the findings of bona fides, another meaning is to be given to the term proper purpose, based on the notion that it is possible to define in the abstract, independent of any question of motive, the ends which a particular power may legitimately be used to attain. The propriety of a particular purpose, in this sense, is a matter of construction of the memorandum and articles, and as such, a question of law. (5)

The doctrine relates to an act which prima facie falls within the powers delegated to the directors but which they have abused by exercising it for an improper purpose. More often than not, this improper purpose for which an act is exercised will be to feather the directors' own nests or to preserve their own control, i.e. for the purposes of self-interest. But this is not always the case, and a duty may be exercised improperly even where it does not involve the self-interest of the directors. (6) It has been suggested that there is an element of ambiguity in the term improper purpose. It may be seen as meaning improper motive and in certain instances the expressions improper motive and improper purpose are used interchangeably. For example, the directors' motive may be to confer a benefit on themselves, or an outsider, or a certain faction of shareholders, or even to injure a particular party or interest (such as a take-over bidder), without any benefit to the company. In this type of situation, the expression improper purpose is simply a restatement in negative terms of the bona fide test. (7)

What must he borne in mind is that cardinal to the doctrine is the exercise of managerial powers of the board of directors, on the one hand, and the exercise of voting powers of the members in general meeting, on the other. If according to the articles, the power of management is vested in the directors, they and they alone can exercise such powers. The contention will be advanced that where directors, in the exercise of their managerial powers, act bona fide in the interests of the company, then, whatever may be their motive or purpose, their acts cannot be set aside and no liability will attach to them. It is not open to the general meeting to usurp these powers. Where directors act outside of or beyond their powers, such acts are unauthorised and are liable to be set aside in terms of the ordinary rules relating to authorisation. If the shareholders are dissatisfied with the manner in which the directors are exercising their managerial powers, their remedy is to act in terms of their constitutional powers in general meeting. Obviously, it is not open to the directors to usurp the powers which are vested by the articles in the general body of shareholders. The situation then is one of management control on the part of directors, and voting control on the part of the members in general meeting. This, it is submitted, gives rise to three possibilities. First, the directors, acting within the scope of their managerial powers, conduct themselves bona fide in the interests of the company. Second, the directors, acting within the scope of their managerial powers, conduct themselves mala fide and contrary to the interests of the company. Third, the directors act beyond their managerial powers and therefore in an unauthorised manner. It will be contended that where directors act bona fide in the interests of the company and within their managerial powers, there is no scope for a further possibility, namely, that their acts are invalid because they conduct themselves for an improper purpose. In other words, liability only attaches to the directors, and their acts are only invalid, if they act beyond their authority or they act mala fide and contrary to the interests of the company.

The most common application of the proper purpose doctrine has been to the power vested in directors to issue shares to avoid a take-over bid. It is clear that the power to issue shares places directors under fiduciary duties in regard to its use. They must act bona fide in the interests of the company and not for some "collateral purpose". The question that arises is how far can directors use their powers to maintain control of the company in friendly hands, i.e. to prevent the predator from affecting the take-over by issuing shares so that he can never gain the requisite majority. The answer to this question has led to a conflict of views. One view is that "directors are not entitled to use their powers of issuing shares merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders". (8) This is so, according to authority, even where the directors genuinely harbour the belief that what they are seeking to do is to prevent the majority of shareholders from doing harm to the company. (9) According to this view, the issue of the shares is liable to be set aside because the power to issue the shares, being a fiduciary power, was exercised for an improper motive. The other view is that where directors seek, by the issue of new shares, to prevent a majority shareholder from exercising control of the company, they will not be held to have failed in their fiduciary duty to the company if they act in good faith in what they believe, on reasonable grounds, to be in the interests of the company. (10) Accordingly, as it has been held, directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the Courts. (11) These opposing views will be analysed and discussed. It will be contended that the modern trend is to extend the scope of directors' managerial powers even to the extent of encroaching upon the powers of members, provided that the acts of directors are exercised <u>bona fide</u> in the interests of the company. The contention will be that if, subjectively, the directors act <u>bona fide</u>, and, objectively, their conduct is justifiable, then such acts will not be invalid nor will any liability attach to the directors thereanent.

Following on from what has been said above, a question that arises is whether the proper purpose doctrine is merely one aspect of the basic duty of directors to act <u>bona fide</u> in the interests of the company, i.e. merely the counterpart of such test in negative terms, or whether it is a completely separate head of directors' duties under which the Court looks objectively at the purpose of a particular power and then determines whether the directors used the power for that purpose, irrespective of whether they were acting in good faith.

In <u>Hogg v. Cramphorn</u> (12) it emerged as a completely separate head of directors' duties. In <u>Harlowe's Nominees Pty Ltd.</u>

v. Woodside (Lakes Entrance) Oil Co. NL (13), however, the High Court of Australia rejected the view that any gloss should be put on the bona fide test which would have the effect, as a matter of law, of "laying down narrow lines within which the concept of the company's interests must necessarily fall". And in Teck Corporation Ltd. v. Millar (14), Berger J rejected the approach of Hogg v. Cramphorn (15), preferring the view that the directors can be said to have abused their powers only where their purpose was not to serve the interest of their company.

In Howard Smith Ltd. v. Ampol Petroleum (16), the Privy Council had an opportunity to review the whole question. The argument, on the one hand, was that once bona fides had been established on the part of the directors, that is, they were not motivated by self-interest, the issue was valid; the counter argument was that once it had been established that the shares were issued for purposes other than the raising of capital, invalidity followed. Both these "extreme" arguments were rejected. The Privy Council endorsed the view, rather, that the proper purposes for which a power is conferred are to be determined as a matter of construction and laid down a basis as to how the articles of a company were to be construed. (17)

More recently, the doctrine has been considered by the Australian Courts without manifesting any unanimity of opinion. (18)

It is in the light of the readiness of some Courts to accept the doctrine, and the reluctance of other Courts so to do, that the proper purpose doctrine is investigated.

In the course of the investigation, the contention will be advanced that in the modern commercial context the trend is to extend the managerial role; to enlarge the scope of the managerial function, and to give a liberal interpretation to what constitutes matters of management. It will not be disputed that the board of directors and the general meeting are the primary organs of the company. Nor will it be disputed that with the expansion of the directors' powers to manage the business of the company, the rights and powers of the members are rendered nugatory. It will be contended that in the light of modern conditions and modern managerial technique, it is the directors who stand at the hub of the company's business wheels; it is they who are best enabled to know what the interests of the company are, and how those interests are best served. Accordingly, even if the rights of individual shareholders are affected, no liability or legal sanction should attach to them, provided they act <u>bona fide</u> in the interests of the company and do not exceed their authority. Thus, according to the contention, there is no need or call for a doctrine of proper purpose.

CHAPTER ONE

(1) Cilliers & Benade: Corporate Law (Butterworths 1987), 226

(2) Joubert: Laws of South Africa (Butterworths 1982), Volume 4, 218

(3) Sealy: Cases and Materials in Company Law (Butterworths London 1985) 3rd ed., 242, 271, 277

(4) [1966] 3 All E.R. 420 (Ch.)

(5) Sealy: op. cit. 278

(6) Howard Smith Ltd. v. Ampol Petroleum [1974] 1 All E.R. 1126 (PC) at 1133

(7) Sealy: op. cit. 271, 277;

(8) Punt v. Symons & Co. Ltd. [1903] 2 Ch 506

(9) See footnote (4) at 428

(10) See footnote (14) below

(11) See footnote (13) below at 493

(12) See footnote (4) above

(13) (1968-1969) 121 CLR 483

(14) (1972) 33 DLR (3d) 188

(15) See footnote (4) above

(16) See footnote (6) above

(17) See footnote (6) above, at 1134

(18) Whitehouse v. Carlton Hotels Ltd. [1987] 5 ACLC 421; Darvall v. North Sydney Brick & Tile Co. Ltd. & Ors. (1988) 6 ACLC 154

CHAPTER TWO

THE NATURE OF THE OFFICE OF DIRECTOR AND THE DISCHARGE OF THE FIDUCIARY DUTIES

The control of the business of a company is usually the responsibility of the board of directors. But what precisely is the nature of the office or the legal position occupied by a director?

Directors have been variously described as agents [1], and as trustees [2]. Whilst such descriptions are not entirely inapposite [3], neither term is sufficiently adequate.

Lord Justice Cairns described the position of a director thus:

> "What is the position of directors of a public company? They are merely agents of a company. The company itself cannot act in its own person, for it has no person: it can only act through directors and the case is, as regards those directors, merely the ordinary case of principal and agent. Wherever any agent is liable those directors would be liable; where the liability would attach to the principal, and the principal only, the liability is the liability of the company." [4]

It is also recognised that directors occupy a position akin to that of a trustee [5]. In this regard, Romer J was constrained to say:-

> "It has sometimes been said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship to the company the statement is true enough. But if the statement is meant to be an indication by way of analogy of what those duties are, it appears to me to be wholly misleading." [6]

The dual character of directors is, perhaps, best expressed by the following words of Lord Selborne:

> "The directors are the mere trustees or agents of the company - trustees of the company's money and property - agents in the transactions which they enter into on behalf of the company." (7)

Despite the fact that the Courts have declined to place directors in a single legal niche for definitional purposes, they have nevertheless clearly defined the duties owed by the directors to their companies (8). For most purposes it is sufficient to say that directors occupy a fiduciary position and all the powers entrusted to them are exercisable in this fiduciary capacity. The fiduciary relationship imposes upon directors duties of loyalty and good faith, which are akin to those imposed upon trustees properly so called. This fiduciary relationship furthermore implies that the fiduciary (in this case a director) must at all times act honestly, loyally and in the best interests of the company.

Directors stand therefore in a fiduciary relationship to their company (9) similar to that between an agent and his principal or a trustee and his beneficiary. This follows partly from the fact that directors act as agents of the company and partly from the fact that in some ways the position of the director resembles that of a trustee. (10) However large their shareholding in the company may be, when dealing with the company's assets, directors deal with property that does not belong to them. Accordingly, they are obliged to act in the company's best interests, not their own. (11)

This fiduciary duty has manifested itself in two fundamental duties:-

(a) a director must use his office and exercise his powers bona fide in the interests of the company. (12) This duty of honesty and good faith in the exercise of his powers is in fact the primary fiduciary duty of a director. The duty imposed upon directors to act bona fide in the interests of the company is a subjective one, that is, the directors must act "bona fide in what they consider - not what the Court may consider - is in the interests of the company". (13) It is left therefore to the directors in the exercise of their business judgment to decide how the interests of the company may best be promoted. The Courts will interfere only if they are satisfied on the evidence that the directors did not act in the best interests of the company. The Courts have made it clear that proof of fraud or dishonesty is not a prerequisite to establishing a breach of fiduciary duty in this regard. It has repeatedly been emphasised that it is quite possible for a director to act honestly and without any fraudulent intent and for his acts not to be in the best interests of the company (14). This is well illustrated by Parke v. Daily News Ltd. (15) which arose out of the sale of the ailing News Chronicle and Star. The Cadbury family, who controlled the selling company, wished to distribute the whole of the purchase price among the employees who would become redundant. At the suit of one shareholder they were restrained from doing so. To the argument that "the prime duty must be to the shareholders; but boards of directors must take into consideration their duties to employees in these days," Plowman J said:

> "But no authority to support that proposition as a proposition of law was cited to me; I know of none, and in my judgment such is not the law".

(b) a director must not place himself in a position in which his personal interests conflict, or may possibly conflict with his duties to the company. (16)

These two general duties essentially form the backdrop against which the Courts over the years have chrystallised the more specific duties which constitute the modern fiduciary duties (17). It is obviously unnecessary for the purposes of this thesis to deal with or even advert to all of these duties. The focus will be on one of these specific duties, i.e. the duty not to act for an improper purpose. It is important at this stage to emphasise that the duty in relation to improper purpose is founded in and derives its authority from the generally recognised principles of a director's fiduciary duties mentioned above.

There are two specific features of these general fiduciary duties which are required to be highlighted at this stage. First, whereas the authority of directors to bind the company usually depends on their acting collectively as a board (save where the authority has been properly delegated or the articles provide otherwise), duties of good faith are owed by each director individually. This principle ensures that the collective wisdom of the board is available to the company on important decisions, and enables discussion to take place before a decision is taken (18). Second, the fiduciary duties are owed to the company and the company alone; the directors owe no such duties to individual shareholders. (19) In Percival v. Wright (20) a person who had approached a director and sold him shares in the company, afterwards, upon discovering that negotiations were afoot for the purchase by an outsider of all the shares in the company at a higher price, could not impeach the contract. Although directors' duties are owed primarily to, and enforceable by, the company and not the individual shareholders, the company is understood thereby to be comprised of the shareholders as a whole and not to be the company as an abstract entity distinct from its members. Indeed the expression "the company" has been held to mean the members as a whole and not some particular section or sections of the membership. (21).

Arising out of these general duties, the first observation is that the directors must act bona fide in what they consider, and not what the Courts consider, is in the interests of the company. (22) That is to say, that the Court is concerned with the state of mind of the directors, with the propriety of the motive on which they acted (23), and will not usurp the function of the directors and consider what is best for the company from a business point of view. Directors may therefore not exercise their powers or use their positions for the purpose of defeating or injuring the interests of the company. (24) Likewise, directors may not exercise their powers for the purpose of furthering their own interests (25) or in the interests of persons other than the shareholders. (26)

In this regard, Gower makes the following points:-

(a) The fact that directors are fiduciaries imposes upon them the subjective duty of honesty and good faith. In other words, the directors must act bona fide in what they believe to be in the best interests of the company. This is tested on common sense principles. (27)

(b) Despite the separate personality of the company it is clear that directors, in being obliged to act in the interests of the company, are not expected to act on the basis of what is for the economic advantage of the corporate entity, disregarding the interests of the members. (28) On the other hand, however, it is manifestly apparent that "the company" does not mean the sectional interests of certain of the members but can mean the interests of creditors. (29)

A director acts in breach of this duty when he causes the company to guarantee his personal indebtedness (30); or to discount a bill of exchange in favour of the company for his private purposes (31); or for his own purposes to pay somebody else's debt (32); or where he pays a cheque drawn in favour of the company into his personal banking account and misappropriates the proceeds of the cheque - even if he is the sole director and the sole shareholder of the company (33); or where he sabotages the company's contractual opportunities for his own advantage or canvasses the company's employees for a trade rival. (34) Such acts are manifestly acts which are not bona fide in the interests of the company and can never constitute an honest exercise by the director of his judgment as to what is in the company's interests. (35)

What appears to emerge from the above investigation is that the question of proper purpose in the exercise of a power by a director is not irrelevant to the question of a breach of his fiduciary duties. Normally, such evidence will be vitally important to a determination of whether the director acted bona fide in the interests of the company. The point, however, must be emphasised that whilst such evidence can in many instances be of assistance, it is not a prerequisite for liability. Proof of acting for an improper purpose by itself will not necessarily be sufficient to found a breach of fiduciary duty. Prior to the decision in Hogg v. Cramphorn (36) (which will feature with some prominence in this dissertation), it was accepted by the Courts that where directors acted bona fide in the best interests of the company such was sufficient to indicate that no breach of a fiduciary duty had occurred, despite the fact that a power had been used for a purpose other than that for which it had been granted. (37) Where, however, powers had been used by directors manifestly for purposes other than that for which they were intended, and not for the benefit of the company, it has been held that such conduct was not bona fide, constituted a breach of a fiduciary duty, and gave cause for the Court to intervene (38).

The formulation of a director's duty to exercise his powers for their true purpose has acquired a specialised meaning as a result of judgments dealing with a directorate which has used its power to issue shares to ensure its continued control over the company instead of using it for its true purpose, namely to acquire additional capital for the company or some other legitimate or justifiable purpose. (39) In several cases the Court has considered the directors' powers to issue shares, and it has been held that "directors are not entitled to use their power of issuing shares merely for the purpose of maintaining their control or the control of themselves and their friends over the affairs of the company, or merely for the purpose of defeating the wishes of the existing majority of shareholders". (40) Such acts have been considered by the Courts to be acts which are not bona fide in the interests of the company. (41) In Hogg v. Cramphorn Buckley J., in holding that the directors had acted for an improper purpose, made it clear that the requirement to act for a proper purpose was distinct from the requirement that directors act bona fide. (42)

Cilliers & Benade (43), citing Hogg v. Cramphorn (44) and Sammel v. President G.M. Co. Ltd. (45) state as follows:-

> "This limitation is also relevant when the directorate exercises its powers to foil a take-over bid for the shares of members. The directors act in breach of their fiduciary duties if they exercise their powers in such a way that they can outvote the majority, whether that majority lies with a take-over bidder or not, merely because of their belief that the party staging the take-over will not serve the interests of the company in the way they would like to see it being done."

The directors must therefore use their powers for their true purpose and not, for instance, for frustrating the wishes of the majority. Thus, according to the doctrine, they will not be allowed to use their powers to allot shares with the object of defeating the pre-existing majority. (46)

CHAPTER TWO

(1) Ferguson v. Wilson (1866) 2 Ch. 77 at 89-90
Peter Loose: The Company Director (Jordans 1975) 5th ed., para. 1-12

(2) Flitcroft's case, Re Exchange Banking Co. (1882) 21 Ch. D 519 at 525

(3) cf. Leveson: Company Directors : Law and Practice (Butterworths 1970), 5

(4) See footnote (1) above

(5) Sealy: "Fiduciary Relationships" [1962] CLJ 69 and [1963] CLJ 119 and "The Director as Trustee" [1967] CLJ 83; Joubert: Laws of South Africa (Butterworths 1982) Vol. 4, para. 164

(6) Re City Equitable Fire Insurance Co. Ltd. [1925] 1 Ch. 407 at 426

(7) Great Eastern Railway v. Turner (1872) L.R. 8 Ch. 149 at 152

(8) Sealy: op. cit. 242; Gower: op. cit. 572

(9) Cilliers & Benade: op. cit. 226

(10) Leveson: op. cit. 114

(11) Ibid: 114

(12) Cilliers & Benade: op. cit. 226; Joubert: op. cit. 213

(13) per Lord Greene MR: In Re Smith & Fawcett Ltd. [1942] Ch. 304 at 306

(14) Re W. & M. Roith Ltd. [1967] 1 All E.R. 427 (Ch.)

(15) [1962] 2 All E.R. 929

(16) Joubert: op. cit. 218; Boardman v. Phipps [1966] 2 All E.R. 721; Bellairs v. Hodnett 1978 (1) S.A. 1109 (A)

(17) Joubert: op. cit. 217-225; Cilliers & Benade: op. cit. 228-230

(18) Palmer's Company Law: 23rd ed. 823

(19) Gower's Principles of Modern Company Law: op. cit. 573

(20) [1902] 2 Ch. 421

(21) Palmer's Company Law: op. cit. 850

(22) See footnote (1) above

(23) Levin v. Felt & Tweeds Ltd. 1951 (2) S.A. 401 (A) at 414 G-H

(24) Atlas Organic Fertilizers (Pty) Ltd. v. Pikkewyn Ghwano (Pty) Ltd. 1981 (2) S.A. 173 (T) at 197

(25) S. v. Hepker 1973 (1) S.A. 472 (W)

(26) See footnote (14) above

(27) Gower: op. cit. 576-577

(28) Ibid: 576-577; Greenhalgh v. Arderne Cinemas [1950] 2 All E.R. 1120 (CA) at 1126

(29) Gower: op. cit. 578

(30) Paddon & Brock Ltd. v. Nathan 1906 TS 158 at 162-164; Harcourt v. Eastman 1953 (2) S.A. 424 (N) at 428-429; Gordon v. Swan Stabilo (SA) (Pty) Ltd. 1979 (3) S.A. 163 (N) at 168-169

(31) Contemporary Refrigeration (Pty) Ltd. v. Leites & Ano. 1967 (2) S.A. 388 (D) at 391

(32) International Sales & Agencies Ltd. v. Marcus [1982] 3 All E.R. 551 (QB)

(33) A.L. Underwood Ltd. v. Bank of Liverpool [1924] 1 K.B. 775 (CA) at 782, 796

(34) Atlas Organic Fertilizers (Pty) Ltd. v. Pikkewyn Ghwano (Pty) Ltd. (supra at footnote (24)) at 197, 200

(35) Henochsberg: Companies Act, 4th ed. 390

(36) [1966] 3 All E.R. 629

(37) Re Smith & Fawcett (supra at footnote (13); Punt v. Symons [1903] 2 Ch. 506 at 516

(38) Punt v. Symons (supra at footnote (37)); Piercy v. Mills & Company, Ltd. [1920] 1 Ch. 77

(39) Cilliers & Benade: op. cit. 232

(40) See footnote (38) above

(41) Henochsberg: op. cit. 390

(42) See footnote (36) above

(43) Cilliers & Benade: op. cit. 232

(44) See footnote (36) above

(45) 1969 (3) S.A. 629 (A) at 282

(46) Cilliers & Benade: op. cit. 232

CHAPTER THREE

THE NATURE AND DEVELOPMENT OF THE DOCTRINE OF PROPER PURPOSE

A director stands in a fiduciary relationship to his company with the result that he has the duty to act in good faith towards his company, to exercise his powers as a director for the benefit of the company and to avoid a conflict between his own interests and those of the company ([1]). The fiduciary duties of loyalty and good faith are not much different from those of anyone else standing in a fiduciary relationship to another (like an agent to his principal or a trustee to his beneficiary) although certain characteristic rules developed in relation to company law ([2]). In view of the indefinable multiplicity of duties imposed on a director by virtue of his fiduciary position, only the general principles relating to certain of those duties will be dealt with.

Firstly, he must avoid conflict of interests, which implies that a director may obtain no other advantage from his office than that to which he is entitled by way of directors' remuneration and that as a rule he may only contract with his company with the approval of a general meeting. Secondly, he must not make use for personal gain of information which he has acquired in his capacity as director. Thirdly, he must maintain and exercise an unfettered discretion. This in turn implies that he must consider the affairs of the company in an objective manner. Fourthly, he must exercise his powers for the purpose for which they were conferred ([3]).

The basis on which a director is held liable by his company for a breach of his fiduciary duty is the general principle that a person standing in a fiduciary relationship to another commits a breach of trust if he acts for his own benefit or to the prejudice of that other (4). Where directors issue shares by which the voting in general meeting would be manipulated in their own interests, they act to benefit themselves and in the result, in breach of their fiduciary duties (5).

DECISIONS BEFORE HOGG V. CRAMPHORN:

In Punt v. Symons & Co. Ltd. (6), in order to determine whether the directors had acted in breach of their fiduciary duties, the determining factor was their bona fides in relation to the interest of the Company. In terms of the company's articles the governing director was given the power to appoint and remove directors. On his death the same power was exercisable by his executors. Friction arose between his executors and the two directors of the company. Of the company's 11000 shares the executors controlled 6300 and the two directors, between them, 3073. The company's articles provided that every question submitted to a general meeting should in the first instance be decided by a show of hands, and that a poll could only be demanded by at least five members. The directors issued eleven shares to five new shareholders and called an extraordinary general meeting for the purpose of passing a special resolution to rescind the articles conferring upon the executors the power to appoint and remove the directors. At this meeting the special resolution was duly passed by virtue of the new shareholders, nine voting for the resolution and three against it, the executors being in the minority.

Byrne J held that the issue of the shares to the five new shareholders was a breach of the directors' fiduciary duties. He said:

> "... I am quite clear that these shares were not issued bona fide for the general advantage of the company, but that they were issued for the immediate object of controlling the holders of the greater number of shares in the company, and of obtaining the necessary statutory majority for passing a special resolution ... A power of the kind exercised by the directors in this case, is one which must be exercised for the benefit of the company: primarily it is given them for the purpose of enabling them to raise capital when required for the purpose of the company." ([7])

It was decided that where shares were issued, in order to obtain sufficient votes to procure an amendment to the articles, which would have deprived certain shareholders of the right to appoint and remove directors, such was an abuse of power by the directors. The basis of the decision was that such conduct was not bona fide for the general interest of the company, i.e. a breach of the basic fiduciary duty.

Similarly, in Piercy v. S. Mills & Co. Ltd. ([8]), the determining factor was the bona fides of the directors in relation to the interests of the company. Here, the directors sought to override the wishes of the holders of the majority of the shares of the company for the time being, by the issue of fresh shares issued solely for that purpose. The question with which Petersen J had to deal, was whether the directors were justified in acting as they did, or whether their conduct was a "breach of the fiduciary powers which they possessed under the articles". (9)

The learned Judge referred to Punt v. Symons & Co. Ltd. (10) and to the case which had featured prominently therein, namely, Fraser v. Whalley (11) and came to the conclusion that:

> "... The Plaintiff and his friends held the majority of shares of the company, and they were entitled, so long as that majority remained, to have their views prevail in accordance with the regulations of the company: and it was not, in my opinion, open to the directors, for the purpose of converting minority into a majority, and solely for the purpose of defeating the wishes of the existing majority, to issue the shares which are in dispute in the present action ... the issue of the shares in question ... was a breach on the part of the directors of their fiduciary powers." (12)

It was thus an abuse of power for directors to make an issue of shares to themselves in order to retain voting control at general meetings, and not in order to raise additional capital for the company. His Lordship's reference with approval to certain aspects of the findings in Punt v. Symons & Co. Ltd. (13) makes it clear that the decision in this case too was based on a breach of the basic fiduciary duty, namely, that the shares had not been issued bona fide for the general advantage of the company. (14)

Thus for directors to abuse their powers or to use those powers for the improper purpose of feathering their own nests or preserving their own control of the company, such will constitute a breach of the duty to act honestly for the benefit of the company as a whole (15). Against such a doctrine there can be no complaint as it is in keeping with the fiduciary role played by directors, and the fiduciary duties imposed upon them. In terms of the doctrine, if a Plaintiff can establish dishonesty or disloyalty or a breach of trust on the part of a director in the exercise of his duties, he will establish liability on the part of the director. Conversely, if the director can prove honesty, loyalty and bona fides, a claim against him will fail, even if the purpose for which he had exercised his powers was improper.

While not a part of the body of case law, it is convenient and instructive at this point to consider what has been referred to as "one of the most informative rulings on the invalidity of the exercise of directors' powers when used for improper purposes", ([16]) namely, that contained in the report of Mr. E. Milner Holland, Q.C. who acted as an inspector to investigate the affairs of Savoy Hotel Ltd. ([17]). The directors of Savoy Hotel Ltd. knew that certain persons were seeking to acquire sufficient shares in the company to give them control of it so that they may compel the board to convert a hotel owned by one of Savoy's subsidiaries into offices. The conversion would undoubtedly have yielded a greater profit to Savoy's subsidiary, and therefore to Savoy, than the continued use of the premises as a hotel. Savoy's directors, however, considered that the retention of the hotel was in the best interests of the company, and they devised a scheme by which it was made impossible for the controlling shareholders of Savoy to carry out the conversion. A new company was formed with a share capital consisting of £640,000 in preference shares and £10,000 in ordinary shares which carried most of the voting rights in general meeting. Savoy's subsidiary sold the hotel to this new company in exchange for preference shares, and the ordinary shares were subscribed for in cash by the trustees of a benevolent fund for Savoy's employees. Savoy's directors knew that the trustees could be relied on to fall in with their wishes in exercising the majority voting rights conferred by the ordinary shares. The new company then leased the hotel back to Savoy's subsidiary, but subject to a covenant that it should be used only as a hotel. It thus became impossible for a controlling shareholder of Savoy to compel its directors to convert the hotel into offices, even if an entirely new board were installed in office.

Mr. <u>Milner Holland</u> observed that the transaction was not carried out for the personal benefit of Savoy's directors, or to perpetuate them in office. After stating the effect of the transaction he said:-

> "... but by no action on their part could the stockholders [of Savoy] ever thereafter alter the decision of their present Board as to the present or future use of the property of the company. The exercise of the directors' powers was therefore used in order to render irrevocable for all time the policy view of the present board. In my opinion, such a use of directors' powers is in principle not distinguishable from an issue of shares to affect voting power, and, however proper the motive behind it, it is not a purpose for which those powers were conferred on the board. Powers conferred by the shareholders on directors for the purpose of managing the business of the company cannot be used for the purpose of depriving those shareholders of such control as under the regulations of the company they may have over the company's assets." (18)

This ruling is generally regarded as the forerunner to the proper purpose doctrine. It was made prior to the decision in <u>Hogg v. Cramphorn</u> (19) and is clearly indicative that the powers given to shareholders by the articles, limited as they often are, cannot be taken away indirectly by the misuse of the board's managerial powers. Furthermore, the criterion for testing the propriety of directors' acts, namely, whether they are for the benefit of the company, does not depend on the directors' own views of what will be best for it, but on whether those acts are designed to achieve the objects which the shareholders constitutionally decide the company shall pursue. (20)

HOGG v. CRAMPHORN:

Hogg v. Cramphorn (21) is a milestone in the development of the proper purpose doctrine. In order to defeat a take-over bid, the directors devised a scheme to increase the potential voting power in their favour by issuing shares to a specially created trust, which was to have loaded votes, and where the shares were paid for by a loan from what in fact were company funds. It was common cause that the purpose of the scheme was to foil the bid to take over the company. The scheme was, however, put into operation because the directors believed that the bidder "had no experience of the particular kind of business carried on by the company"; that "there would be a change in the nature of the company's trading"; and that "the offer would unsettle the company's staff". (22).

The court held that:-

> "... the directors were not actuated by any unworthy motives of personal advantage, but acted as they did in an honest belief that they were doing what was for the good of the company ... I am sure that Col. Cramphorn and also probably his fellow directors firmly believed that to keep the management of the company's affairs in the hands of the existing board would be more advantageous to the shareholders, the company's staff and its customers

> than if it were committed to a board selected by (the bidder)." (23)

The Court accordingly accepted that "the board acted in good faith and that they believed that the establishment of a trust would benefit the company and that avoidance of the acquisition of control by (the bidder) would also benefit the company" (24). Nonetheless, the Court went on to add:-

> "I must still remember that an essential element of the scheme, and indeed its primary purpose, was to ensure control of the company by the directors and those whom they could confidently regard as their supporters. Was such a manipulation of the voting position a legitimate act on the part of the directors?" (25)

The Court accordingly came to the conclusion that it was not "open to the directors ... to say 'We genuinely believe that what we seek to prevent the majority from doing will harm the company and, therefore our act in arming ourselves or our party with sufficient shares to outvote the majority is a conscientious exercise of our powers under the articles, which should not be interfered with'. Such a belief, even if well-founded, would be irrelevant ... The power to issue the shares was a fiduciary power and if ... it was exercised for an improper motive, the issue of these shares is liable to be set aside." (26) Thus, notwithstanding that directors act honestly in what they believe to be the benefit of the company, they may nevertheless be liable if they exercise their powers for a purpose different from that for which the powers were conferred on them. (27)

The decision in <u>Hogg v. Cramphorn</u>, however, seems to mark a point of departure from the accepted doctrine, and gives rise to the possibility of the establishment of a different doctrine of proper purpose, and a new basis for liability on the part of directors. The conduct of the directors involved a frustration of the powers of the members in general meeting, but the Court found that they bona fide considered their conduct to be in the interests of the company (28). Nonetheless, the Court held that the directors had acted in breach of their fiduciary duties (29). It follows, in the light of this decision, that liability can attach to directors irrespective of clear proof of bona fides on the part of directors in respect of their conduct (30).

On an analysis of the decision of Buckley J in Hogg v. Cramphorn (31), the essential characteristic of the new doctrine is a separation of the duty to act bona fide in the interests of the company, from the duty to exercise a fiduciary power for the purpose for which it was intended and not for some improper motive. On the one hand, Buckley J held "that the directors had not been actuated by any unworthy motives of personal advantage, but acted as they did in an honest belief that what they were doing was for the good of the company" (32); and on the other hand, "that an essential element of the scheme and indeed its primary purpose, was to ensure control of the company by the directors and those whom they could confidently regard as their supporters (33) ... it was exercised for an improper motive ..." (34).

The decision in Hogg v. Cramphorn (35) has attracted considerable academic interest and comment. In order to determine the nature of the doctrine, the viewpoints of certain of the writers on the subject will be considered.

Beuthin assesses the gravamen of Buckley J's finding thus:

> "Although Buckley J did not expressly say so, his decision seems to involve a rejection of the idea that the 'purpose' for which powers are conferred upon directors is inextricably linked with their duties of good faith". (36)

J.R. Birds, in summing up the proper purpose doctrine, as it arose out of the judgment in Hogg v. Cramphorn, suggests that it is not "merely one aspect of the basic duty of directors to act bona fide in the interests of the company". Rather, it is "a completely separate head of directors' duties under which the Court looks objectively at the purpose of a particular power and then determines whether the evidence of the directors used the power for that purpose, irrespective of whether they were acting in good faith". (37)

Gower, in analysing the doctrine, similarly draws a distinction between what may be described as a bona fide related purpose, such as directors feathering their own nest or preserving their own control of the Company and thereby attracting liability, and a non-bona fide related purpose, such as where directors have acted honestly in what they believe to be to the benefit of the company, but nevertheless are still held liable for exercising their power for an improper purpose:-

> "If directors exercise their powers for purposes other than those for which they were conferred, it may be said that they had exceeded their authority and are liable accordingly. But it probably makes for clarity to distinguish between an act ultra vires the directors because they have usurped a power which they never had, and an act which prima facie is within the powers delegated to them but thich they have abused by exercising it for an improper purpose. The former hardly seems to be a breach of the fiduciary duty of good faith: the latter

is. Often the improper purpose will be to feather the directors' own nests or to preserve their own control, in which event it will be a breach of the duty, already considered, to act honestly for the benefit of the company as a whole. But it is clear that notwithstanding that directors have acted honestly in what they believe to be the benefit of the company they may nevertheless be liable if they have exercised their powers for a purpose different from that for which the powers were conferred upon them." (38)

Gore-Brown refers to the various powers to which the doctrine has been held applicable and comes to the following general conclusion.

"But the principle (the doctrine of proper purpose) is without doubt one of general application, to be invoked in relation to any power whose purpose can clearly be discerned from the articles. It is submitted that ... the consequences of infringement of the principle are the same as apply in relation to the principle of bona fides ... " (39)

Obviously, the judgment of Buckley J in Hogg v. Cramphorn (40) has given rise to considerable judicial reaction. Before this case law is discussed, certain observations are made as to the nature of the newly-emerged doctrine. Firstly, it is manifestly clear that a doctrine of proper purpose has always existed as an essential aspect of the exercise by directors of their fiduciary duties. This doctrine, however, was integrally bound up with the requirement that directors act bona fide in the interests of the company. Where they acted out of self-interest, such would constitute a breach of the duty to act honestly for the benefit of the company as a whole. In other words, the impropriety of the director's acts, and the attendant liability, was determined by an application of the "bona fide in the interests of the company" test, and no other. L.S. Sealy suggests that there is an element of ambiguity in the term "improper purpose" (or "collateral purpose"). He goes on to say that:

> "It may be seen as meaning improper motive; and in some cases cited the expressions 'improper motive' and 'improper purpose' are used interchangeably. For example, the directors' motive may be to confer a benefit on themselves, or an outsider, or a certain faction of shareholders, or even to injure a particular party or interest (such as a take-over bidder) without any benefit to the company. In this type of situation, the expression 'improper purpose' is simply a restatement in negative terms of the '<u>bona fide</u>' test." (41)

Secondly, and largely arising out of the <u>Hogg v. Cramphorn</u> case (42), circumstances could present themselves where directors do not act for any purposes of self-interest, and act honestly in what they believe to be the benefit of the company, and yet be liable if they have exercised their powers for a purpose different from that for which the powers were conferred upon them. This is the new doctrine of proper purpose, the essential elements of which seem to be: arising out of the duty upon directors to act <u>bona fide</u> in the interests of the company, a determination must be made as to whether they did act <u>bona fide</u> in the interests of the company or not. If they did not so act, then they are in breach of their fiduciary duties and this completes the investigation (43). If <u>bona fides</u> on the part of the directors has been established, the investigation then turns on whether the directors have acted for a proper purpose or not. This obviously necessitates a determination of what the purpose of their action was. If, in the exercise of their powers, they acted for a purpose other than that for which such powers are construed as having been conferred, such will be indicative of the powers being exercised for an improper purpose, and could give rise to liability on the part of the directors, despite the presence of <u>bona fides</u>. Sealy sums up this "new approach", i.e. where <u>bona fides</u> on the part of directors was expressly found, or conceded, but their "purpose" was nevertheless declared "improper" and their decision struck down, as follows:-

> "Commentators have sought, in the light of the finding of bona fides, to give another meaning to the term 'improper purpose', based on the notion that it is possible to define in the abstract, independently of any question of motive, the ends which a particular power may legitimately be used to attain." (44)

This new doctrine manifestly gives rise to a new basis of liability, i.e. even if the director satisfies the Court that he acted bona fide in the interests of the company, he can still be liable. This gives rise to numerous questions: does such a doctrine exist? Is there support for such a doctrine? It is proposed to investigate and scrutinize the averments in support of the doctrine, and to test the doctrine in the light of judicial decisions subsequent to that in Hogg v. Cramphorn (45).

The case law following upon the decision in Hogg v. Cramphorn (46) is now considered.

DECISIONS AFTER HOGG v. CRAMPHORN:

In Harlowe's Nominees (Pty) Ltd. v. Woodside (Lake's Entrance) Oil Co. (47), the company which was engaged in oil and gas exploration allotted 9 million 50 cent shares, paid up to 10 cents each, but at a premium of 20 cents to a large oil company with ample resources, subject to a detailed agreement with the allottee company. It was alleged by an existing shareholder, with an interest in between 10,3% and 17,3% of the issued capital, that the company had at the time no immediate need of additional share capital and that the directors, to the knowledge of the allottee company, had caused the shares to be allotted for the purpose of preventing the plaintiff shareholder from obtaining the voting power it expected to obtain by buying the shares on the open market and of safeguarding their positions as directors of the company and that thereby the allotment and issue of the shares was not made bona fide and in the interests of the company as a whole.

In the Court of first instance, the trial judge expressed the view that, on the evidence, the purpose of the allotment and issue of the shares was not to defeat the plaintiff's attempt to obtain control or preserve the directors' positions on the board of the company, but was to ensure the financial stability of the company. On this ground the action was dismissed. The matter went to the higher Court who affirmed the decision of the trial judge. Significantly, it was stated by the Court of Appeal that:

> "... there may be occasions when the directors may fairly and properly issue shares for other reasons (i.e. other than to raise capital), so long as these reasons relate to a purpose benefiting the company as a whole, as distinguished from a purpose, for example, of maintaining control of the company in the hands of the directors ... but the ultimate question must always be whether in truth the issue was made honestly in the interests of the company ..." (48)

It is respectfully submitted that the effective decision of the Appeal Court is two-fold: firstly, the ultimate test is whether the issue was made honestly in the interests of the company; and secondly, provided that the actual purpose of the directors in making the issue is to advance the economic interests of the company, then no fiduciary duty is breached.

The decision seems to be in conflict with that pronounced in Hogg v. Cramphorn [49]. At the least, there appears to be a reluctance to follow a doctrine of proper purpose, and rather to remain committed to the basic duty of acting *bona fide* in the interests of the company.

The Canadian case of Teck Corporation Ltd. v. Millar [50] is now considered. Teck Corporation which held a majority shareholding in Afton Mines Ltd., indicated an intention to replace the board of Afton with its own nominees with the view to causing Afton to enter into an agreement with itself (Teck) for the exploration by Teck of mineral rights owned by Afton. Before this could be done, and in order to prevent it, the directors of Afton concluded an exploration agreement with another company. One of the provisions of the agreement, according to common practice in this type of agreement in Canada, provided for the issue to the other company of a large number of shares in Afton, thus displacing Teck's majority. In an action brought by Teck against Afton, Teck acknowledged that Afton's directors had not acted purely out of self-interest and that they may well have considered it to be in the best interest of Afton to defeat Teck's majority. Nonetheless, on the strength of the decision in Hogg v. Cramphorn [51], it was argued that Afton's directors had violated their fiduciary duties.

Berger J declined to follow Hogg v. Cramphorn [52] and relied upon the "basic unchallenged principle of equity", namely that "they (the directors) must exercise their discretion bona fide in what they consider - not what a Court may consider - to be in the interests of the company, and not for any collateral purpose." (53) Effectively this decision of Berger J was two-fold. Firstly it declined to follow the decision in Hogg v. Cramphorn (54). The learned Judge opined as follows:-

> "I think that directors are entitled to consider the reputation, experience and policies of anyone seeking to take over the company. If they decide, on reasonable grounds, a take-over will cause substantial damage to the company's interests, they are entitled to use their powers to protect the company." (55)

Secondly, it took the view that the only "improper purpose" was a purpose not designed to serve the best interests of the company. (56)

On analysis, the conclusion cannot be escaped that in the view of Berger J, the proper purposes doctrine is not a separate rule of equity but merely an aspect of the broader principle that the directors must act bona fide in the interests of the company. The learned Judge said:

> "I think that the Courts should apply the general rule in this way: The directors must act in good faith. Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose." (57)

It is submitted that in the judgment there is manifested a reluctance to impose upon a director any duty other than to act bona fide in the interests of the company.

Howard Smith Ltd. v. Ampol Petroleum (58) also involved an issue of shares. Ampol, together with a related company controlled approximately 55% of the issued shares in a company known as R.W. Millar (Holdings) Ltd. Ampol submitted a bid to Miller for the remaining shares but this was rejected as too low by the board of directors. A rival take-over bid was made by Howard Smith Ltd. at a slightly higher price which the majority of the directors favoured. Thereupon, Ampol joined forces with another substantial shareholder and announced an intention to reject the Howard Smith offer. Meanwhile Millers needed capital which it was in the process of raising by means of loan capital. To overcome Ampol's opposition, the board of Millers allotted unissued shares to Howard Smith which had the effect of providing the needed capital but at the same time diluted the holdings of Ampol and placed them in a minority position. In the result the Howard Smith bid proved possible by the vote of all the shareholders other than Ampol. Ampol sought, successfully, to invalidate the allotment.

At the trial in the Equity Division of the Supreme Court of New South Wales, the Chief Judge in Equity, Street J, found, firstly, that the allotment had not been made by the directors of Millers for any reason of self interest. Secondly, it was held that the primary purpose of the allotment was not to satisfy any need for capital but to destroy the majority holding of Ampol, thus opening the way to the success of the Howard Smith offer. On the basis of these findings the learned Judge ordered that the issue of shares be set aside. The Privy Council upheld this decision. One argument advanced was that, for validity, what was required was bona fide exercise of the power in the interests of the company and that once it is found that the directors were not motivated by self interest, i.e. by a desire to retain their control of the company or their positions on the board, the matter was concluded in their favour and that the Court would not enquire into the validity of their reasons for making the issue. In other words, the invalidity of an issue of shares was directly related to directors having acted through self interest. The argument advanced on the other side was that the purpose for which the power was conferred was to enable capital to be raised for the company, and that once it was found that the issue was not made for that purpose, invalidity follows. (59) The Court regarded these opposing standpoints as "the extreme positions" and opined that neither could be maintained. (60) It held that although the majority of cases in which an issue of shares had been challenged were cases in which the self interest of directors was the vitiating element, it did not follow that the absence of any element of self interest was enough to make the issue valid. (61)

On the issue whether a fiduciary power has been exercised for the purpose for which it was conferred, it was the opinion the the Court that:-

> "... it is necessary to start with a consideration of the power whose exercise is in question, in this case a power to issue shares. Having ascertained on a fair view, the nature of this power, and having defined as can best be done in the light of modern conditions the, or some of the limits within which it may be exercised, it is then necessary for the Court, if a particular exercise of it is challenged, to examine the substantial purpose for which it was exercised, and to reach a conclusion whether that purpose was proper or not." (62)

But their Lordships went on, and therein, it is submitted, manifested an ambivalence in relation to accepting a separate and distinct doctrine of proper purpose:-

> "In doing so it will necessarily give credit to the bona fide opinion of the directors, if such is found to exist, and will respect their judgment as to matters of management; having done this, the ultimate conclusion has to be as to the side of a fairly broad line on which the case falls." (63)

In referring to "matters of management", their Lordships were, of course, applying the principle of division of powers between the directors and the general meeting. They adverted, on the one hand, to the powers of management afforded to directors in terms of the constitution; and, on the other hand, to the voting powers of the shareholders in general meeting. (64) On this score they were able to achieve two distinct ends: Firstly, they were able to distinguish the instant case from the cases of Harlowe and Teck, which, according to their Lordships, involved considerations of management, within the proper sphere of the directors. (65) Secondly, they were able to come to the conclusion that just as directors, within their management powers, were entitled to make decisions against the wishes of the majority of shareholders, so it was unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. Furthermore the exercise by the directors of the fiduciary power solely for the purpose of shifting the power to decide to whom and at what prices shares were to be sold could not be related to any purpose for which the power of the share capital had been conferred on them. (66) The Court accordingly came to the conclusion that the power had been improperly exercised. (67)

In determining whether a power had been exercised by the directors for an improper purpose, the Court determined certain factors that ought to be taken into account, namely:-

(a) a consideration of the power in question;

(b) a definition of the limits of the power "in the light of modern conditions";

(c) an examination of the substantial purpose for which the power was exercised;

(d) a giving of credit to the <u>bona fide</u> opinion of the directors;

(e) a respecting of the judgment of directors as to matters of management; (68)

<u>Birds</u> does not accept that the decision of the Court unequivocally supports the doctrine of proper purpose. It is his opinion that the judgment is "inclined towards the midway view" between the doctrine being "merely one aspect of the basic duty of directors to act <u>bona fide</u> in the interests of the company" and "a completely separate head of directors' duties" (69). This opinion seems to be based upon the requirement of the Court to give "credit to the <u>bona fide</u> opinion of the directors" and to respect "the judgment of the directors as to matters of management". (70)

While it can hardly be argued that the decision of the Court rejects the doctrine of proper purpose, it is submitted that the decision does not clearly support the doctrine, nor does it overtly distinguish a separate doctrine from the basic bona fide doctrine.

Their Lordships' accepted the principle that regard must be had to "the surrounding circumstances ... which genuinely throw light upon that question of the state of mind of the directors so as to show whether they were honestly acting in discharge of their powers in the interests of the company or were acting from some bye-motive, possibly of personal advantage, or for any other reason". (71)

Furthermore, it was held "the law should not impose such a limitation (i.e. shares may be issued only for the purpose of raising capital for the company) on directors' powers. To define in advance exact limits beyond which directors must not pass ... is impossible" (72) and that the Court "will necessarily give credit to the bona fide opinion of the directors ... and will respect their judgment as to matters of management ..." (73)

RECENT AUSTRALIAN DECISIONS:

The judgments in two recently decided Australian cases are now considered. The first of these cases is Whitehouse & Ano. v. Carlton Hotel Pty Ltd. (74)

Charles Whitehouse was the permanent governing director of respondent company. The articles of association of the company provided that all powers, authorities and discretion vested in the board of directors were exercisable by the permanent governing director alone. On 10 January 1974, in purported exercise of that discretion, he issued two "B" class shares to each of his two sons. The effect of the issue was to dilute the voting power attaching to the shares held by his former wife and to prevent his daughters and their husbands from gaining control over the company. In 1980, Whitehouse sought to reverse the purported allotments, having then fallen out with his sons. At first instance, the sons sought an order that the register be rectified by the entry of their names as holders of two "B" class shares.

The case enjoyed the attention of three separate Courts, namely, the Supreme Court of Queensland ([75]); the Full Court of the Supreme Court of Queensland ([76]), and the High Court of Australia ([77]). In the Court of first instance, Andrews, S.P.J. found in favour of the plaintiffs. In the Full Court, Kelly J with whom Matthews J concurred (Carter J dissenting) found in favour of the defendants. In the High Court, Mason, Deane and Dawson JJ (Wilson and Brennan JJ dissenting) confirmed the decision of the Full Court. The end result was that four judges decided in favour of the plaintiffs and five in favour of the defendants, the majority favouring the invalidity of the issue. An analysis of the various judgments reveals a distinct uneasiness on the acceptance of a doctrine of proper purpose. Indeed, there are strong arguments to be advanced that the dissenting judgments are to be preferred.

In the Court of first instance, the learned judge dealt with various matters arising out of the allegations made by the defendants to the effect that the purported allotment of shares was null and void with no effect (78). Andrews S.P.J. held that the aid of the Court had not been sought to assist the plaintiffs in the furtherance of any improper purpose and that therefore the allotment was valid (79). The learned trial judge found that in making the allotments Charles Whitehouse had taken steps to ensure that the plaintiffs would retain control over the management of defendants' affairs after his death and that the purpose of the alteration of control was to ensure that the daughters and their husbands would not, by the exercise of their voting power, gain control over the company, the business of which was likely to be better and more efficiently controlled by his sons. (80) On the Hogg v. Cramphorn line this would amount to an exercise of power for an improper purpose and would thus fall to be struck down.

Significantly, though the learned judge found the exercise of this power to be valid despite the above because he was "satisfied that at the time the allotments were made Charles had the interests of the company at heart". (81)

In the majority judgment of the Full Court, Kelly and Matthews JJ, accepted these findings of the trial judge but came to the conclusion that:-

> "The power was not used bona fide and I am of the opinion that the purpose for which it was exercised was not a proper one. For these reasons in my view the allotments were invalid ..." (82)

Although linked to a proper purpose, the Court's finding was based on an absence of the bona fide use of the power. (83)

Carter J, in his dissenting judgment, after an analysis of the judgment in Howard Smith v. Ampol Petroleum (84), came to the following conclusion:-

> "Since therefore in the instant case, the effect of the allotment is to create a new majority, it must follow, so it is submitted, that the exercise by Charles of his fiduciary powers 'must be unconstitutional'. I do not understand his Lordship to express a general principle that any allotment of shares which creates a new majority and destroys an existing one is necessarily invalid. Indeed, his Lordship rejected the maintenance of 'extreme positions' taken by the protagonists in that case in favour of one which requires 'the substantial purpose' for which the power was exercised to be examined. Lord Wilberforce rejected the exposition in express terms of any general proposition, relating to the exercise of directors' powers, of the kind for which the appellant here contents. At p. 835 he said:
>
> > 'To define in advance the exact limits beyond which directors must not pass is, in their Lordships' view, impossible. This clearly cannot be done by enumeration, since the variety of situations facing directors of different types of companies in different situations cannot be anticipated'". (85)

On the strength of the factual findings of the trial judge Carter J held:

> "In this case, the findings of the learned trial judge are consistent only with the conclusion that against a background of intense family disharmony and given the apparent prosperity of a long established family business, the substantial purpose of the allotment was to ensure that upon his death the control of the company should pass into experienced hands rather than to those who were not only inexperienced but who also at the time were intent on winding up the family business. He therefore, upon advice, sought to achieve his purpose by the challenged allotment rather than by an alteration of the articles of association, something which could only occur, in any event, with his consent; see cl 8 of the memorandum of association. In the light of the findings of the learned trial judge as to the substantial purpose for the allotment, I find myself unable to disagree with his conclusion, that in all of the circumstances, the allotment by Charles did not involve an abuse of the power given to him by the articles of association." (86)

In the High Court, the factual findings of the trial judge as affirmed by the Full Court were not challenged although emphasis was placed on the fact that the purpose of the allotment was to dilute the voting power by creating a new majority. [87] The majority of the Court accepted that:-

> "It is arguable that special circumstances may arise in which the dilution of the voting power of an existing shareholder or group of shareholders or the creation of new voting power may constitute a legitimate purpose to be pursued by directors in the exercise of a fiduciary power to allot shares." [88]

but went on to hold:-

> "In that regard, it is unavailing that Mr. Whitehouse was not motivated by purely selfish considerations in that he believed that the manipulation of voting power in favour of his sons at the expense of his former wife was in the interests of the company in that it would ensure that the management of the company after his death was in the hands of those whom he favoured." [89]

Following the judgment in Hogg v. Cramphorn [90] the finding of the majority was that:-

> "In this as in other areas involving the exercise of fiduciary power, the exercise of a power for an ulterior or impermissible purpose is bad notwithstanding that the motives of the donee of the power in so exercising it are substantially altruistic." [91]

and in the result found that the purported allotment of the shares was invalid. [93]

The approach of Wilson J (dissenting) was different in that he held that:-

> "The consideration of the issue of improper purpose must begin with the general proposition that the power to allot shares is a fiduciary power which must be exercised bona fide for the benefit of the company as a whole.

This is a broad statement of principle which is not to be confined within narrow criteria." (93)

In line with this approach the learned judge found that:-

"All the circumstances surrounding the allotment must be considered in the search to discover the substantial object of those taking the action:" (94)

"It may also be observed that an objective consideration which tends to support the conclusion that the allotments were made bona fide in the interests of the company as a whole lies in the fact that the interests of the "C" class shareholders were closely identified with the future stability and profitability of the company." (95)

It is of significance that the learned judge:-

"... derived considerable assistance in the consideration of this case from the judgment of Berger J. in Teck Corporation Ltd. v. Millar (1972) 33 D.L.R. (3d) 288, a decision which the Judicial Committee in Howard Smith (at 836-837) considered to be in line with the English and Australian authorities discussed in that case. The case provides a striking illustration of the propriety of directors taking action which they bona fide believed to be in the best interests of the company notwithstanding that it had the effect of destroying the voting power and intentions of the majority shareholder. In the course of reaching his decision, Berger J. engages in a critical discussion of the decision of Buckley J. in Hogg v. Cramphorn Ltd. [1967] Ch. 254 where his Lordship took the view that the directors have no right to exercise their powers to issue shares, in order to defeat an attempt to secure control of the company, even if they consider that in doing so they are acting in the company's best interests." (96)

and that he found that:

"... the approach of Berger J. is consistent with the approach of this Court in Harlowe's Nominees Pty. Ltd. v. Woodside. It is supportive of the case advanced for the appellants." (97)

In the result the learned judge concluded that the findings of the trial judge ought not to have been disturbed and that the appeal should be allowed. [98]

The other dissenting judgment (per Brennan J) is no less instructive. The judgment indicates an acceptance of the factual findings of the Court of first instance, i.e. that the ultimate purpose of the allotments was the better and more efficient control of the company; [99] and an emphasis being laid upon the basic fiduciary duty of acting bona fide in the interests of the company:-

> "When an issue of shares has the double effect of raising needed capital and buttressing shareholder support for the directors, it may be a nice question whether the directors made the issue honestly in the interests of the company albeit with the realisation that the result would be agreeable to them or whether in making the issue they had an actual purpose of creating an advantage for themselves otherwise than as members of the general body of shareholders:" [100]

Obviously one cannot ignore the majority judgment and that it supports the proper purpose doctrine. At the same time it is clear that there was a distinct uneasiness to accept such a doctine as separate from the basic doctrine to act bona fide in the interests of the company and a reluctance to follow Hogg v. Cramphorn [101].

The second case is Darvall v. North Sydney Brick & Tile Co. Ltd. & Ors. [102].

The judgment by Hodgson J in the Supreme Court of New South Wales dealt with two issues, one of which related to an alleged breach by a director of First Defendant of his fiduciary duties. The case did not deal with an issue of shares but a commitment of the company by the directors to a joint venture scheme to develop certain land owned by their company ("Norbrik"). The company's most substantial asset was a large parcel of land which had been left undeveloped. Over a period of 32 years this land had increased enormously in value to $60 million. In the early 1980's Norbrik commenced investigating various development options for the land. The board undertook to consult the members in general meeting before committing the company to a particular option. In June 1986 D, a shareholder in Norbrik, notified the company of his intention to make an offer for all the shares in Norbrik at a price of $10 per share. Previous trading of Norbrik shares had been at 87c per share. Norbrik's board of directors opposed D's offer believing it not to be in the best interests of the shareholders. The board advised shareholders not to accept the offer describing it as "grossly inadequate". In August 1986, less than 3 months after D's take-over offer was announced, the board of directors committed Norbrik to a joint venture scheme to develop the land. [103]

D brought proceedings seeking an order setting aside the joint venture agreement on the ground that it involved a breach by the directors of Norbrik of their duty to act honestly and in the best interests of the company and that it also amounted to an improper exercise by them of their power as directors of Norbrik. [104]

On behalf of the plaintiff ("D"), it was submitted that where the exercise by the directors of a corporate power is challenged, two questions arise: firstly, were the directors acting in good faith in what they considered to be in the interests of the company; and secondly, was the power exercised for the purpose for which it was conferred, or for some extraneous purpose. [105]

The existence of subjective good faith, it was submitted, was insufficient to save the purported exercise of the power, if the power was exercised for a collateral purpose. If the directors came to the conclusion that the plaintiff's offer was inadequate, or otherwise should not be accepted, that justified no stronger action on their part than the giving of full information to the shareholders so that they could make an informed decision as to where their interests lay, and the making of recommendations if the directors thought it appropriate to do so. According to the submission, it was unconstitutional for the directors to use their fiduciary powers for the purpose of preventing a person acquiring a majority of shares. The submission went further to suggest that if the purpose of frustrating action was to endeavour to obtain a higher price for shareholders, that would not render this purpose proper. It was submitted that if the Court found as a fact that but for a desire to prevent the plaintiff from acquiring a majority of shares in terms of the offer, the directors would not have entered into the transaction upon the terms which they did, then the transaction was voidable as an abuse of power and the joint venture should accordingly be set aside. [106]

On behalf of the defendants it was submitted that in order to succeed, the plaintiff had to prove that the action of the directors in entering into the joint venture agreement was not <u>bona fide</u> in the interests of the company as a whole, but for an improper or collateral purpose. Further, it had to be shown that such improper or collateral purpose was the substantial purpose of the directors. If the decision or action sought to be impeached was taken <u>bona fide</u> in the interests of the company as a whole, it did not matter that it was taken in the context of a takeover offer or even actuated by the fact that a take-over offer had been made. According to the submission, and on the authority of <u>Teck</u>'s case (107), in exceptional cases, the directors could take steps for the purpose of actually frustrating a take-over offer where they believe that the offer was not in the interests of the company as a whole. (108)

Arising out of the submissions made on behalf of the respective parties, the learned Judge raised three particular legal questions: First, to whom did the directors owe their duty; second, what were the characteristics of the purpose which caused a directors action to be impugnable; third, to what extent may directors take steps in opposition to a proposed take-over offer. (109) The learned Judge was not constrained to give a narrow answer to the first question and held that directors had to have regard to the interests of members of the company, both present and future, as well as to the interests of the company as a commercial entity, and to the interests of the creditors of the company. (110) In answer to the second question, the essential characteristic of the purpose giving rise to the invalidation of the act in question is that such purpose was causative in the sense that, but for its presence, the power would not have been exercised, i.e. it did not have to be the dominant purpose. (111)

In relation to the third question, Hodgson J referred firstly to what was stated in Teck's case (112), namely, that "directors are entitled to consider the reputation, experience and policies of anyone seeking to take over the company. If they decide, on reasonable grounds, a take-over will cause substantial damage to the company's interests, they are entitled to use their powers to protect the company." (113) Secondly, the learned Judge referred to an unreported judgment by Megarry V.-C. in Cayne v. Global Natural Resources, where his Lordship said:-

> "If company A and company B are in business competition, and company A acquires a large holding of shares in company B with the object of running company B down so as to lessen its competition, I would have thought that the directors of company B might well come to the conclusion that it was contrary to the best interests of company B to allow company A to effect its purpose, and that in fact this would be so. If, then, the directors issue further shares in company B in order to maintain their control of company B for the purpose of defeating company A's plans and continuing company B in competition with company A, I cannot see why that should not be a perfectly proper exercise of fiduciary powers by the directors of company B. The object is not to retain control as such, but to prevent company B from being reduced to impotence and beggary, and the only means available to the directors for achieving this purpose is to retain control. This is quite different from directors seeking to retain control because they think they are better directors than their rivals would be." (114)

In the opinion of the learned Judge, the relevant question was whether directors were justified in the face of a take-over offer in hastening to cause the company to enter into commercial arrangements, with the view to presenting to shareholders alternatives which may be more attractive than the take-over offer. In other words, where directors were of the view that to accept the take-over offer would be disadvantageous to the shareholders, might they cause the company to enter into agreements with a view to demonstrating to shareholders that it is not in their interests to accept the take-over offer? Hodgson J came to the conclusion that they could, "at least as long as they believe that the agreements or arrangements do advance the commercial interests of the company". (115)

It is not insignificant that the learned Judge, in approaching the question and in coming to his conclusions, did so against the background of whether the duty owed by directors was to the company as a corporate entity, or to the present members of the company, or some other body or persons. Interestingly enough, his assessment on this aspect of the matter was that it should not be approached from a narrow point of view. In other words, in contrast to the earlier and more traditional point of view and no doubt in keeping with "modern conditions", it was proper for directors to have regard to the interests of the members of the company, both present and future, as well as having regard to the interests of the company as a commercial entity, and the interests of the creditors of the company. Thus it was open to directors to take into account the circumstance that many of the shareholders wished to obtain substantial cash for their shares in the short term; that they had been offered a sum which the directors considered to be inadequate, and that they could in association with the entry into the joint venture agreement be secured an offer in a more substantial sum, which more closely approached the true value of the shares, and to act accordingly. (116)

In keeping with this approach, the learned Judge said, in attempting to characterise the relevant purpose or purposes of the directors, it was necessary "to take a fairly broad approach" (117):-

> "On the whole, as I have said, I think I must take a fairly broad approach and look for the subtantial purposes of the board as a whole. In doing so, I think it is important to ensure that the relevant purposes be characterised fairly: in one sense, it may be that the substantial purpose of the directors was to defeat the plaintiff's bid, but it may also be that this is not a fair characterisation of the relevant purpose." (118)

He went on to hold:-

> "However, I think that the directors did believe that in the circumstances of the existence of the offer, the joint venture agreement was in the best interests of the company and of its present shareholders, independently of any question of the directors retaining their control of the company. In my view, in general, the directors thought that acceptance by shareholders of an offer of $10 would not be in the best interests of shareholders, and thought that in order to demonstrate this fact, it was necessary that urgent positive steps be taken towards the development of the land." (119)

> "In one sense, then, it was a substantial purpose of the directors to defeat the plaintiff's bid; but as I foreshadowed, I do not consider that to be a fair characterisation of their purpose. I think a fair characterisation of their purpose would rather be in terms of bringing about a situation where shareholders (some of whom wanted ready cash for their shares) would have alternatives, apart from acceptance of the plaintiff's offer.
>
> It follows that in my view the plaintiff has not made out a case for avoidance of the joint venture agreement on the basis of improper purpose." (120)

The Court held thus that the directors were under a duty to have regard to the interests of the present and future members of the company as well as the interests of the company as a commercial entity and of creditors of the company. It also held that where directors were of the view that many shareholders may accept a take-over offer and that to do so would be disadvantageous to those shareholders, the directors may cause the company to enter into agreements or arrangements with the view to demonstrating to the shareholders that it is not in their interests to accept the take-over offer provided that the directors believe that the agreements or arrangements were in the best interests of the company. In the result, the conduct of the directors did not constitute a breach of fiduciary duty.

In keeping with the findings in Whitehouse v. Carlton Hotel Ltd. ([121]), the Court held that a director's action would be impugned if there was an improper purpose which were causative in the sense that but for its presence the action would not have been taken, regardless of whether that purpose was the dominant one or but one of a number of significantly contributing causes. Having found thus, however, and having found that the directors would not have entered the joint venture agreement "but for" the making of D's offer, the Court nonetheless found that a case for avoidance had not been made out on the basis of improper purpose. This was because the directors believed that in the circumstances of the existence of the offer, the agreement was in the best interests of the company and its shareholders, independently of any question of the directors retaining their control of the company.

On the basis of the above, one would have expected Hodgson J to have found in favour of the Plaintiff but he did not.

In framing the legal questions which it proposed to consider, the Court placed the general contention of the plaintiff in a very narrow ambit, namely, whether the relevant purpose was the dominant purpose of the directors, or whether it may extend to a purpose which is among a number of dominant purposes, that is, purposes but for which the impugned action would have been taken. [122] Second, in an application of the doctrine, the Court was not inclined towards any strict approach. It was "necessary to take a fairly broad approach" and it was "important to ensure that relevant purposes be characterised fairly" [123], i.e. "in one sense, it may be that the substantial purpose of the directors was to defeat the plaintiff's bid, but it may also be that this is not a fair characterisation of the relevant purpose. [124] While Hodgson J did not refer to the "test" laid down in Howard Smith [125], it would seem that he was either extending the test, or even formulating a new test in characterising the relevant purpose or purposes of the directors. Third, the question of the subjective state of mind of the directors clearly influenced the Court, for as the learned Judge was wont to say:

> "... I think that the directors did believe that in the circumstances of the existence of the offer, the joint venture agreement was in the best interests of the company ..." [126]

Fourth, the Court seemed influenced by the fact that the purposes for which the directors had acted were independent "of any question of the directors retaining their control of the company". [127]

Against this background, it is respectfully submitted that the Court, in coming to the conclusion that "the plaintiff (had) not made out a case for avoidance of the joint venture agreement on the basis of improper purpose", was reluctant to apply strictly a doctrine of proper purpose; was reluctant to separate such a doctrine from the "bona fide in the interests of the company" duty; was more inclined to the approach in Harlowe's [128] and Teck's [129] cases rather than that in Hogg v. Cramphorn [130]; and preferred even a wider approach to that taken in Howard Smith [131]

CHAPTER THREE

(1) Cilliers & Benade: Corporate Law 226; Joubert: The Law of South Africa Vol. 4 para 161

(2) Cilliers & Benade: Company Law 3rd ed. 237; Gower's Principles of Modern Company Law 4th ed. 572;

(3) Cilliers & Benade: Ibid 236-241; Joubert: op. cit. paras 221-229; Henochsberg on the Companies Act 4th ed. 389-393; Gower: Ibid 576-577

(4) Cilliers & Benade: op. cit. 229; Henochsberg: Ibid 390

(5) Punt v. Symons [1903] 2 Ch. 506; Piercy v. S. Mills & Co. Ltd. [1920] 1 Ch. 77

(6) Punt v. Symons [1903] 2 Ch. 506

(7) pp. 515-516

(8) Piercy v. S. Mills & Co. Ltd. [1920] 1 Ch. 77

(9) p. 82

(10) See footnote (6) above

(11) Fraser v. Whalley (1864) 2 H. & M. 10

(12) pp. 84-85

(13) See footnote (6) above

(14) p. 84

(15) Gower: op. cit. 581

(16) Pennington's Company Law, 5th ed., 670

(17) The report was published in 1954

(18) Pennington: op. cit. 670

(19) [1966] 3 All E.R. 420 (Ch.)

(20) Pennington: op. cit. 671

(21) See footnote (19) above

(22) pp. 422-423

(23) p. 426

(24) p. 427

(25) Ibid.

(26) p. 429

(27) Gower's Principles of Modern Company Law, 4th ed., 581; Joubert: The Law of South Africa, Vol. 4, para. 221

(28) at 427 D-E

(29) at 428 F-H

(30) Gower: op. cit. 581

(31) at 426-428

(32) at 426F

(33) at 427 D-E

(34) at 428H

(35) See footnote (19) above

(36) (1967) SALJ 349 at 354

(37) (1974) 37 MLR 580

(38) Gower: op. cit. 580/581

(39) Gore-Brown on Companies, 43rd ed., para. 27-10

(40) See footnote (19) above

(41) L.S. Sealy: Cases & Materials in Corporate Law, 3rd ed., 277

(42) See footnote (19) above

(43) Gore-Brown: op. cit. para. 27-9

(44) L.S. Sealy: op. cit. 277/278

(45) See footnote (19) above

(46) Ibid.

(47) (1968/69) 121 CLR 483

(48) p. 493

(49) See footnote (19) above

(50) (1972) 33 D.L.R. (3d) 288

(51) See footnote (19) above

(52) Ibid.

(53) Re Smith and Fawcett [1942] 1 All E.R. 542

(54) See footnote (19) above

(55) p. 317

(56) p. 312

(57) pp. 315/316

(58) [1974] 1 All E.R. 1126 (PC)

(59) p. 1133

(60) _Ibid_.

(61) _Ibid_.

(62) p. 1134

(63) _Ibid_.

(64) p. 1135

(65) _Ibid_.

(66) _Ibid_.

(67) p. 1136

(68) p. 1134

(69) (1974) 37 MLR 580

(70) See footnote (68) above

(71) p. 1133

(72) pp. 1133-1134

(73) p. 1134

(74) (1987) 5 ACLC 421

(75) (1985) 3 ACLC 87 _coram_ Andrews S.P.J.

(76) (1985) 3 ACLC 713 _coram_ Matthews, Kelly and Carter JJ

(77) See footnote (74) above _coram_ Mason, Wilson, Brennan, Deane and Dawson JJ

(78) See footnote (75) above at 89

(79) See footnote (75) above at 97/98

(80) See footnote (76) above at 719 and (75) above at 97

(81) _Ibid_.

(82) See footnote (76) above at 721

(83) _Ibid_.

(84) [1974] 1 All E.R. 1126 (PC)

(85) See footnote (76) above at 726

(86) _Ibid_.

(87) See footnote (74) above at 423

(88) See footnote (74) above at 426

(89) _Ibid_.

(90) [1966] 3 All E.R. 420 (Ch.)

(91) See footnote (74) above at 426

(92) See footnote (74) above at 427

(93) See footnote (74) above at 430

(94) See footnote (74) above at 431

(95) See footnote (74) above at 432

(96) See footnote (74) above at 432/433

(97) See footnote (74) above at 433

(98) _Ibid_.

(99) See footnote (74) above at 434-436

(100) See footnote (74) above at 436

(101) See footnote (90) above

(102) (1988) 6 ACLC 154

(103) pp. 154-155

(104) p. 155

(105) p. 174

(106) _Ibid_.

(107) _Teck Corp. v. Millar_ (1972) 33 D.L.R. (3d) 288

(108) pp. 174-175

(109) pp. 175-176

(110) p. 176

(111) _Ibid_.

(112) See footnote (107) above

(113) p. 176

(114) p. 177

(115) _Ibid_.

(116) p. 176

(117) p. 177

(118) _Ibid_.

(119) pp. 177-178

(120) p. 178

(121) See footnote (74) above

(122) pp. 175-176

(123) p. 177

(124) _Ibid_.

(125) See footnote (84) above

(126) p. 177

(127) _Ibid_.

(128) (1968/1969) 121 CLR 483

(129) See footnote (107) above

(130) [1966] 3 All E.R. 420 (Ch.)

(131) See footnote (84) above

CHAPTER FOUR

CONCLUSION

BASIC PRINCIPLES:

It has been observed that there are certain basic principles which cannot be disputed. The first is that a director stands in a fiduciary relationship towards his company. Second, and arising out of this fiduciary relationship, there are imposed upon directors certain fundamental fiduciary duties, namely, he must use his office and exercise his powers bona fide in the interests of the company, and he must not place himself in a position where his personal interests conflict with his duties to the company. Third, where directors act to satisfy a self interest, such an interest is extraneous.

DOCTRINE OF PROPER PURPOSE : ITS ACCEPTANCE AND REJECTION:

It has also been observed that the doctrine has not met with universal judicial acclaim or acceptance. The decision in Hogg v. Cramphorn (1) was distinguished in Harlowe's Nominees (Pty) Ltd. v. Woodside (Lake's Entrance) Oil Co. (2); indeed, there appeared to be a distinct reluctance to follow the doctrine of proper purpose. In Teck Corporation Ltd. v. Millar (3) the decision was expressly rejected. The diversity of opinions expressed by the several judges in the various Courts which heard Whitehouse & Ano. v. Carlton Hotel Pty Ltd. (4) indicates an unease at a ready acceptance of the doctrine. In Darvall v. North Sydney Brick & Tile Co. Ltd.

& Ors. (5) considerable prominence was given to cases such as Harlowe's Nominees (Pty) Ltd. v. Woodside (Lake's Entrance) Oil Co. (6) and Teck Corporation v. Millar (7), while no mention was made to the decision in Hogg v. Cramphorn (8). The decision in Darvall's case (9), likewise, manifests a distinct reluctance to accept the doctrine of proper purpose.

THE APPROACH OF THE COURTS:

Thirdly, it has been observed that as a general proposition it may be said that the Courts are reluctant to confine or restrain or limit directors in the exercise of their powers of management. This is so even if the "directors' opinion of the needs of the company was imprecise, probably intuitive and maybe erroneous", as long as each of the directors has addressed his mind to the relevant problem and exercised the power bona fide. (10) In the Howard Smith case (11) it was said that the Court would respect the judgment of directors as "to matters of management", and that the conclusion of the Court in the matter of an abuse by directors of their powers "has to be as to the side of a fairly broad line on which the case falls". (12) This tendency to broaden the managerial role of directors and extend the scope of their activities even to the extent of encroaching upon the constitutional powers of members is to be detected in the references to the application of the powers of directors in the modern commercial context. It is to this aspect of the matter that attention is now directed.

THE TRADITIONAL AND MODERN PERCEPTIONS OF THE ROLE OF DIRECTORS:

In Teck Corporation Ltd. v. Millar (13) Berger J referred to the "classical theory" which, according to the learned judge, is that the directors' duty is to the company. The company's shareholders are the company. Therefore no interest outside those of the shareholders can legitimately be considered by the directors. This, of course, in some degree, begs the question, in that, what falls within the definition of the interests of the shareholders, and, by what standards are the shareholders' interests to be measured? Nonetheless, it accords with long established principle (14).

Berger J went on to opine that "a classical theory that once was unchallengeable must yield to the facts of modern life" (15). According to the learned Judge the "classical theory" had yielded "to the facts of modern life" and he states a number of propositions. First, if the directors of a company, in the modern context, were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Second, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy, it could not be said that they had not considered bona fide the interests of the shareholders. Third, and appreciating that it would be a breach of their duty to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees, if they were to observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, leave directors open to the charge that they have failed in their fiduciary duty to the company.

Against the background of what he describes as "the modern 'managerial' technique of management" where "directors are conceived ... as standing at the hub of the company's business wheels" (16), Beuthin (17) raises two interesting questions: "to what interests may the directors legitimately have regard in their management of the company's business?" and "may they (the directors), in appropriate cases, allow those other interests to override possibly conflicting interests of the shareholders?"

Many years before the enactment of Section 309(1) of the Companies Act (18), it was Beuthin's opinion that directors were entitled to have regard to the interests of the company's employees in so far as those interests may consequentially affect the interests of the company (19). But he does not confine his comments to the interests of the company's employees. In a series of searching questions he adverts to the "interests of the consumer"; "the interests of the public"; the "interests of the State"; "the interests of the company's overseas image", (20), and he comes to the conclusion (as with employees) that it is within the sphere of the director's duty to consider and satisfy the interests of "customers, trade connections, the local community and the nation" (21). It is his considered view that:-

> "Public opinion no longer shares the view that directors should always be compelled to act 'in the interests of the company', regarding only those matters as relevant which in some way or another are capable of feathering the shareholder nest." (22)

> "... the horizons of his (the director's) boardroom extend a great deal further than the share register ..." (23)

Moreover, while no such general directors' duty has yet been formulated by a South African Court, and while there are some dicta which reject the suggestion (24), there are other dicta in some cases to the effect that directors are under a duty to have regard to the interests of creditors (25).

The question that arises is how wide a latitude ought the directors to have. Thus if a person or group is seeking to obtain control, must they be ignored, or must the directors blindly follow the decisions of the general meeting in regard thereto. Does a blind following of the decisions of the general meeting constitute a discharge of their fiduciary duty to act bona fide in the interests of the company. Or are they entitled to consider the consequences of such group taking over. If they do, and act thereupon in what they believe to be in the interests of the company, do they act in breach of their fiduciary duties. Ought not directors to be allowed to consider who is seeking control and the reason therefor. Moreover, having made their investigation and having bona fide and for good reason come to the conclusion that there will be substantial damage to the company's interests if the company be taken over, then to exercise their powers to defeat those seeking majority, can such conduct necessarily be categorised as improper. Otherwise stated: if the directors conclude that the take-over will be detrimental to the interests of the company, and they do not exercise their powers to defeat the majority-seekers, will this not constitute a breach of their fiduciary duties.

Tunc quotes from Northwest Industries, Inc. v. The B.F. Goodrich Co. (26):

> "Management has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or its stockholders. In arriving at such a judgment, management should be scrupulously fair in considering the merits of any proposal submitted to its stockholders. The officers' and directors' informed opinion should result from that strict impartiality which is required by their fiduciary duties. After taking these steps, the company may then take any step not forbidden by law to counter the attempted capture" (27).

His own view is that "it is difficult to take issue with this approach or to see on what grounds it might be attacked" (28).

Obviously there must be a limit to the exercise of the directors' powers and such limits ought to be clearly defined but must such limit of the directors' powers go to the extent of that required by Hogg v. Cramphorn? (29)

If one accepts that the exercise of a particular power must be seen "in the light of modern conditions" (30), or that the classical theories "must yield to the facts of modern life", (31) and if credit must be given "to the bona fide opinion of the directors" (32), and if "their judgment as to matters of management" are to be respected (33), then, is the general rule not that the directors must act in good faith? There must, of course, be reasonable grounds for their belief that there will be substantial damage to the company's interest and in its absence the Court will be justified in finding that the directors were actuated by an improper motive. (34)

DIRECTORS' POWERS OF MANAGEMENT:

The trend in accordance with "the facts of modern life" (35) and "in the light of modern conditions" (36), it is submitted, is two-fold: first, it is to extend the powers of directors and thereby to limit the rights of shareholders. Second, it is to give a liberal interpretation to the powers of directors in their management of the business of the company. Palmer (37) does suggest that even broadly worded particular articles conferring powers upon directors must be construed in the context of the articles as a whole in order to establish whether any limitation should be read into the article conferring apparently unlimited power. He goes on, however, to say that on a proper construction of the articles no such limitation should be implied. (38)

Gower (39) says that the directors are the primary organs of the company and that they can "if they are so advised, to disregard the wishes and instructions of the members in all matters not specifically reserved (either by the Act or the articles) to a general meeting" until such time as the general meeting exercises its powers to amend the articles and to remove the directors.

This means that articles, if appropriately framed can cut down on the rights of shareholders to any extent which the articles on their true construction permit. Indeed, there is nothing in principle or authority to make it impossible to draft such a wide and comprehensive power to directors so as to enable them to take into account any matter which they conceive to be in the interests of the company.

Where the articles are framed with some limitation on the discretionary power of directors, it follows that if they go outside the matters which the articles say are to be the matters to which they are to have regard, the directors will have exceeded their powers and acted beyond their authority. The question, therefore, is whether on a true construction of the particular article, the directors are limited by anything except their bona fide view of the interests of the company. Where the articles are drafted in the widest possible terms, the Court will not write into that clear language any limitation other than a limitation which is implicit by law, that a fiduciary power must be exercised bona fide in the interests of the company. Subject to the "bona fide in the interest of the company" qualification, an article in this form can give to the directors an absolute and uncontrolled discretion.

As to the latitude given to the directors or the limitation imposed upon them in the exercise of their powers, the learned judge in Harlowe's case found (40):

> "Directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts. Thus in the present case it is not a matter for judicial concern, if it be the fact, that the allotment to Burmah would frustrate the ambitions of someone who was buying up shares as opportunity offered with a view to obtaining increased influence in the control of the company, or even that the directors realized that the allotment would have that result and found it agreeable to their personal wishes: Mills v. Mills. But if, in making the allotment, the directors had an actual purpose of thereby creating an advantage for themselves otherwise than as members of the general body of shareholders, as for instance by buttressing their directorships against an apprehended attack from such as Harlowe, the allotment would plainly be

> voidable as an abuse of the fiduciary power, unless Burmah had no notice of the facts."

In regard to the latitude that ought to be afforded to directors in the matter of the management of the business of the company in relation to a take-over situation, it was the view of the Court in Teck's case (41) that directors ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interests if the company was taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorised as improper. The Court was of the view that it was not sound to limit the directors' exercise of their powers to the extent required by Hogg v. Cramphorn Ltd. (42). It accordingly declined to follow that decision. In coming to a conclusion Berger J referred to the judgment in Savoy Corp. Ltd. v. Development Underwriting Ltd. (43) where regard was had to "the structure of modern companies and of modern business life in the following terms:

> "It would seem to me to be unreal in the light of the structure of modern companies and of modern business to take the view that directors should in no way concern themselves with the infiltration of the company by persons or groups why they bona fide consider not to be seeking the best interests of the company."

The ultimate question, according to the learned judge in Harlowe's case (44) "must always be whether in truth the issue was made honestly in the interests of the company".

THE RIGHTS AND ROLE OF MEMBERS:

The rights and powers of the members are those vested by the articles in the general body of shareholders. When a company's constitution makes no provision for a particular matter the members have inherent powers to deal with it (45). Moreover, even if specific powers have been assigned to the directors the members can still exercise those powers in certain circumstances (46). The general meeting also has powers to amend the articles; to remove the directors and to substitute others, and to this extent it retains ultimate control (47). Directors, obviously, cannot usurp the powers which by the articles are vested in the members, and where they endeavour so to do, they exceed their powers to act beyond their authority.

In addition, a shareholder has propriety rights in relation to his shares exercisable in the normal course. As such, he enjoys the freedom to dispose of his propriety interest whensoever and to whomsoever he pleases. This is an unfettered right. If, therefore, the shareholder wishes to sell his shares to a party, the fact that the purchaser happens to be on the take-over trail, is a factor which can be held in complete indifference. The motives of the purchase do not concern the shareholder and he is not legally obliged (and some might suggest is not morally obliged) to concern himself with the motives of the prospective purchaser. It would therefore be nothing more than blatant impertinence for the directors to presume to prescribe to the shareholders what is in their own interests and for their own good. That decision is one which lies solely in the province of the shareholder.

While this cannot be disputed the fact remains that where the articles confer on the directors the power to manage the business of the company, the directors can disregard the wishes of the shareholders in all matters not specifically reserved to the general meeting. It is clear that in the modern context, an increasingly wide interpretation is being placed on the "management clause" in company articles (48). Accordingly, where directors exercise their powers bona fide in the interests of the company, they ought not to attract liability or be subject to legal sanction, even if the rights of individual shareholders are affected (49).

It is not contended that the powers of directors ought to be unlimited; nor is it contended that shareholders should have no rights. The contention that is being advanced is that in the modern context where directors stand "at the hub of the company's wheels" (50) there is no scope for an additional head of directors' fiduciary duties, namely, to act for a proper purpose. Where directors act beyond their authority, the appropriate legal remedy is avalable to shareholders. Where, however, they act bona fide in the interests of the company such conduct should be allowed to override conflicting interests of the shareholders.

THE DECISION IN HOGG v. CRAMPHORN: (51)

Certain observations are to be made concerning the basic fiduciary duty to act bona fide in the interests of the company. First, it involves a subjective approach, i.e. as to what the directors genuinely believed when exercising their powers. Second, it involves an objective approach in that regard must be had to the presence of reasonable grounds for the directors' exercise of their powers as the test of good faith. Subjectively, the directors in a matter of dealing in the company's shares must have considered the consequences of a transfer of control, and objectively, they must have acted upon reasonable grounds. Obviously, if there are no reasonable grounds for the directors' alleged belief, and their purpose was merely to exercise control over a group of shareholders, then the basic bona fide duty is breached, and the transaction is liable to be set aside. If then, objectively, the take-over would have had profound consequences for the company's whole way of doing business and subjectively, the directors believed that it would damage the company's interests, then reasonable grounds for the exercise of the directors' powers would be found to exist.

In Hogg v. Cramphorn (52), the Court accepted "that the directors were not actuated by unworthy motives of personal advantage, but acted as they did in an honest belief that they were doing what was good for the company". (53) This satisfies the subjective requirement. It would seem also that the Court accepted that there were reasonable grounds for this belief, i.e. that the scheme would be likely to prevent the displacement of an experienced management by an inexperienced one. This, it is submitted, satisfies the objective requirement.

Was the Court therefore right in proceeding to adopt the approach that the primary purpose of the scheme "was to ensure control of the company by the directors and those whom they could confidently regard as their supporters"; (54) and was the Court justified in asking the question: "Was such manipulation of the voting position a legitimate act on the part of the directors?" (55) Did the Court not err in then proceeding on the basis of the principle of the separation of the company's powers and thereby impose too strict a limitation on the exercise of the powers of directors as opposed to the exercise of its constitutional rights by the majority?

In his analysis of the decision in Hogg v. Cramphorn, L.S. Sealy submits that:-

> "... the learned judge ought to have considered himself free, both on authority and on the merits of the case, to uphold the directors' own bona fide view that their action was in the best interests of the company. There should be no test other than the genuineness of the directors' own motive, provided of course that their view is one that could reasonably be held - the line is drawn short of their being 'amiable lunatics'". (56)

Tunc in his assessment of the decision is more explicit:-

> "Why did not the learned judge distinguish the case on the basis that the two preceding decisions (i.e. Punt v. Symons and Co. Ltd. and Piercy v. Mills & Co. Ltd.) were cases of 'dishonest improper purpose' while he was facing an 'honest improper purpose'? ... But when in a given case a judge has stated: '... I am quite clear that these shares were not issued bona fide for the general advantage of the company', why is it that a subsequent judge feels bound by this decision in a case when the directors 'acted as they did in an honest belief that they were doing what was for the good of the company'? What is more, Byrne J., in the first case, had taken pains to repeat that the power to issue shares 'must be exercised for the benefit of the company: primarily ... to raise capital' but occasionally 'for other reasons'. Would not a holding in favour of the board in Hogg v. Cramphorn Ltd. have been in perfect accordance with the first case?" (57)

Three possible situations present themselves: first, the directors usurped powers reserved to the members and thereby exceeded their authority. Second, the directors acted to ensure control of the company and therefore were not bona fide in the exercise of their powers. Third, the directors acted bona fide in the interests of the company. In neither the first nor the second of the situations was there any need to introduce a new doctrine. In the third, the Court ought to have held in the favour of the directors.

SUMMING UP:

In the exercise of their fiduciary duties, directors are required to exercise their powers bona fide in the interests of the company. If they fail to act bona fide in the interest of the company, they open themselves to liability and to legal sanction. Where, in the past, directors acted bona fide in the interests of the company, they properly discharged their fiduciary duties.

A new doctrine seems to have arisen. Notwithstanding good faith on the part of directors, if, in the exercise of their powers, they acted for some improper purpose, they, nonetheless, attracted liability and opened themselves to legal sanction. It is submitted that there is no basis for such a doctrine.

Directors are given the power to manage the affairs of the company. They must exercise the power in good faith and according to their best judgment. They are fiduciaries and not omniscients. They manage the business of the company in a modern commercial context. The trend of this modern commercial context is to extend the managerial role; to enlarge the scope of the managerial function, and to give a liberal interpretation to what constitutes matters of management. It is the directors who must decide where the company's best interests lie and how they may best be served; and in so doing they may have to have regard to a wide range of practical considerations.

The Courts have always shown a reluctance to confine or restrain or limit directors in the exercise of the powers of management; to define limits beyond which directors must not pass; and to substitute its discretion for the discretion given to directors.

Obviously, directors cannot be allowed to exercise their powers free of restraint or limitation; neither can shareholders be denuded of all forms of control. Wherein does the balance lie? It is respectfully submitted that the restraints and limitations imposed upon directors should be confined to the following:-

(a) they must not exceed their authority;

(b) they must exercise their powers <u>bona fide</u> in the interests of the company, and where they do there must be no recourse against the directors, even if the rights of individual shareholders are affected. In determining whether the directors have acted <u>bona fide</u> in the interests of the company, the Court must adopt a subjective approach in order to determine what the directors genuinely believed when exercising their powers. Second, the Court must adopt an objective approach to determine the presence of reasonable grounds for the directors' exercise of their powers.

The fact cannot be escaped that a form of the doctrine of proper purpose exists. The contention, however, is advanced that there is a reluctance to accept an unqualified doctrine. It is further contended that as the line broadens between the management rôle of directors and the constitutional role of shareholders respectively, so the doctrine will move back within the framework of the basic "bona fide" test.

The dichotomy which seems to present itself, namely as to what the law should, or is likely, to be; and the law as it is, is stated by Gore-Brown as follows:-

> "Modern management often takes the view that the interests to be taken into account by directors in running a company should include the interests of not only the present and future shareholders, but also the company's employees, its customers and creditors and, in the case of large companies at least, the State and the general public. No doubt this represents an adequate practical guide for most decisions that a director has to take. It is, however, estabished that from the point of view of strict law, 'the interests of the company' means those of the present and future shareholders alone, and that the only circumstances in which the directors may legitimately promote the interests of any of the other groups or entities mentioned are where to do so ultimately advances the interests of the shareholders." ([58])

CHAPTER FOUR

(1) [1966] 3 All E.R. 420

(2) (1968/1969) 121 CLR 483

(3) Teck Corporation Ltd. v. Millar (1972) 33 DLR (3d) 288 at 309

(4) (1987) 5 ACLC 421

(5) (1988) 6 ACLC 154

(6) See footnote (2) above

(7) See footnote (3) above

(8) See footnote (1) above

(9) See footnote (5) above

(10) See footnote (2) above at 499. In Teck's case (at 307) the approach was confirmed when Berger J held that the directors were elected to exercise their best judgment. They were not agents bound to accede to the directions of the majority of the shareholders. Their mandate continued so long as they remained in office.

(11) [1974] 1 All E.R. 1126 (PC)

(12) *Ibid*.

(13) See footnote (3) above

(14) Smith & Fawcett Ltd., In re, [1942] Ch 304

(15) See footnote (3) above at 314

(16) R.C. Beuthin: "The Range of a Company's Interests" 1969 S.A.L.J. 155 at 164

(17) *Ibid*. at 156 and 158

(18) Companies Act 1985

(19) See footnote (16) above at 158

(20) pp. 158-159; 169-171

(21) p. 164

(22) p. 164

(23) p. 168

(24) Sealy: *op. cit*. 248-249

(25) per Lord Diplock in Lonrho Ltd. v. Shell Petroleum [1980] 1 WLR 627 HL at 634 F

(26) 301 F.Supp. 706 (N.D. 111 1969)

(27) A. Tunc: (1984) 47 MLR 150 at 156 *

(28) _Ibid_.

(29) See footnote (1) above

(30) See footnote (11) above at 1134

(31) See footnote (3) above at 314

(32) See footnote (11) above at 1134

(33) _Ibid_.

(34) See footnote (3) above at 315

(35) See footnote (3) above at 314

(36) See footnote (11) above at 1134

(37) Palmer's _Company Law_ 23rd ed. 856

(38) See: Cilliers & Benade: _Corporate Law_ 175

(39) Gower's _Principles of Modern Company Law_ 4th ed. 152

(40) _Ibid_.

(41) See footnote (3) above

(42) See footnote (1) above

(43) (1963) N.S.W.R. 138 at 147

(44) _Ibid_.

(45) Cilliers & Benade: _op. cit_. 173

(46) _Ibid_.

(47) _Ibid_.; see also Gower: _op. cit_. 152

(48) Cilliers & Benade: _op. cit_. 175

(49) See footnote (16) above at 168

(50) _Ibid_. 164

(51) See footnote (1) above

(52) _Ibid_.

(53) _Ibid_. 426

(54) _Ibid_.

(55) *Ibid.*

(56) [1967] Camb. L.J. 33 at 35

(57) See footnote (3) above at 157-158

(58) Gore-Brown: *op. cit.* para. 27-9; also Gower: *op. cit.* p. 578

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